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WHEN ARE TWO SETTLEMENTS ONE ARRANGEMENT?

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1 Scope of the Article

In this article, I discuss the meaning of "settlement for the United Kingdom capital gains tax Offshore Beneficiary Provisions and in particular whether two classic settlements between which there is a transfer of assets might constitute one arrangement. While this question has always been smoldering, it has recently become red-hot as a result of the implementation of a tax avoidance scheme which involves a transfer of assets between two classic settlements. The scheme, if successful, ensures that the funds of the transferor settlement can be transferred to beneficiaries absolutely without stockpiled trust gains being visited on them.

2 Settlements and Settlements

There are two definitions of settlement for capital gains tax purposes. One is that impliedly contained in Taxation of Chargeable Gains Act 1992 section 68, which defines settled property, unless the context otherwise requires, to mean any property held in trust other than property to which section 60 above (nominees and bare trustees) applies.[2] One surmises that settlement is to be construed accordingly and means that state of affairs which exists when trustees hold settled property on trust. While this definition is normally the applicable one for capital gains tax purposes,

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2 Also outside the definition is property held by a trustee or assignee in bankruptcy or under a deed of arrangement.

and in particular for the Offshore Settlor Provisions,[3] the Offshore Beneficiary Provisions[4] define settlement in a way which is arguably both wider and narrower.

I shall refer to a settlement within the normal meaning as a classic settlement, as this meaning is very close to the traditional Chancery meaning of settlement. I shall refer to a settlement within the definition for the purposes of the Offshore Beneficiary Provisions as a section 87 settlement.

3 Section 87 Settlements and the Income Tax Definition

3.1 Incorporation of Income Tax Definition

Taxation of Chargeable Gains Act 1992 section 97(7) provides:

> In sections [86A]2 to 96 [and Schedule 4C]3 and in the preceding provisions of this section-
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> > settlement and
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> > settlor have the meaning given by [section 660G(1) and (2)]1 of the Taxes Act and
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> > settlor includes, in the case of a settlement arising under a will or intestacy, the testator or intestate, and
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> > settled property shall be construed accordingly.

3.2 The Income Tax Definition

Taxes Act 1988 section 600G provides:

> (1) In this Chapter-
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> > settlement includes any disposition, trust, covenant, agreement, arrangement or transfer of assets, and

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3 Taxation of Chargeable Gains Act 1992 section 86 and Schedule 5.

4 Taxation of Chargeable Gains Act 1992 sections 87-97(1) - (6) and Schedule 4C but not Schedule 4B. Section 97(7) contains the definition. Its inapplicability to section 97(8)-(10) is somewhat surprising, but is arguably of limited significance.

> settlor, in relation to a settlement, means any person by whom the settlement was made.

This definition goes back, ultimately, to Finance Act 1920 section 22, although its precise form has changed from time to time over the years. There is a great deal of case law regarding its application to income tax.

The definition is not a masterpiece of drafting. The word settlement is used in several senses in current English. It can indeed mean an historical event, the act whereby a state of affairs came into being. Disposition, covenant, agreement, arrangement and transfer of assets are words apt to describe such an historical event, whereas trust is not.[5] Its more usual meaning is the continuing state of affairs brought about as a result of the act of settling. Disposition, covenant, agreement and transfer of assets are not apt words to use in this sense. Trust is. Arrangement is as ambiguous as settlement and can refer to a continuing state of affairs which has been arranged in the past. In which sense is settlement used in the section 660G definition? There are references in Part XV Chapter 1A to income arising under a settlement,[6] and to payments made by virtue or in consequence of the settlement.[7] Settlement almost certainly bears the meaning of an historic act of settling. Income arising under a settlement is simply income arising in consequence of the settlement.

3.3 Applying the Income Tax Definition in a Capital Gains Tax Context

The adoption of this definition for the purposes of the Offshore Beneficiary Provisions was not properly thought through.[8] In its original income tax context, it is enough for one to find that there has been a settlement (in effect, an act of bounty) by a person, who is therefore the settlor, and then to find income arising in consequence of that act of bounty. If one of the other conditions of application of

5 Declaration of trust, by contrast, is.

6 Section 660A(1) and (8).

7 Section 660B(2)

8 I made representations on this point to the Revenue through the Technical Committee of the Institute of Taxation, as it was then called, when it was first proposed to introduce the income tax definition for the purposes of what was then Finance Act 1981 section 80. I am not sure to what extent they were understood. They could not be answered and were consequently ignored.

the provisions is satisfied,[9] the income is deemed to be that of the settlor. That presents no logistical problems. It does not matter whether there is a trust or not. There is no definition of trustee. There does not need to be. One looks simply to the person to whom the income would belong for tax purposes but for the provisions.[10] There is no definition of the settled property. There does not need to be. All one needs to do is to identify the property from which arises the income arising under, i.e. in consequence of, the settlement.

In the context of section 87, the position is much more difficult. In order for the section to apply, there must be trustees of the settlement who realise chargeable gains and persons who receive capital payments from those trustees: see section 87(2) and (4).[11] Such trustees must have a residence status and be chargeable to capital gains tax but for that residence status. Now one can realise capital gains and make capital payments to another and have a residence status and be chargeable to capital gains tax only if one is a person for the purposes of the tax. Thus, one must find an individual, a company, as defined, personal representatives or the trustees of a classic settlement. Although one may find a disposition, trust, covenant, agreement, arrangement or transfer of assets, none of these is a person. For this reason, it would appear that in general it will be difficult for anything which is not a classic settlement to be a section 87 settlement.[12] By contrast, a classic settlement will not be a section 87 settlement if the necessary bounty was lacking.

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9 I.e. if, broadly, the income arises from property in which the settlor has an interest, if minor, unmarried children of the settlor benefit in specified ways or if a capital payment has been made to the settlor in specified circumstances.

10 See in particular section 660D(1) and (2).

11 Until 1991, the recipients of the capital payments also needed to be beneficiaries: the extended definition of this term in what is now section 97(8) being added by Finance Act 1991. Until 1998 there needed to be settlor of the settlement: the concluding words of section 87(1) were repealed by Finance Act 1988. The amendments made by these Finance Acts cannot have altered the meaning of settlement in the Offshore Beneficiary Provisions.

12 Arguably an arrangement consisting of or including a company could be a section 87 settlement: see the income tax cases of *Commissioners of Inland Revenue v Payne* (1940) 23 TC 610; *A G Chamberlain v Commissioners of Inland Revenue* (1943) 25 TC 317, although *Commissioners of Inland Revenue v Levy* (1982) 56 TC 68; [1982] STC 442 would suggest that this would be in only an exceptional case. The trustee would in that case be the company. A difficulty would then arise as to the interaction between Taxation of Chargeable Gains Act 1992 sections 13 and 87. It is arguable that section 13 is a self-contained and exclusive code for the attribution of gains of offshore companies to others.

3.4 The Author's view

That in itself is, in my view, a complete answer to any argument that two classic settlements constitute one section 87 settlement. The trustees of two classic settlements cannot constitute the trustees of one section 87 arrangement settlement.[13] They are simply the trustees of two separate section 87 settlements, each one corresponding to and consisting of one of the classic settlements.

3.5 Problems Arising from Contrary view

If, for some reason, I am wrong, the following questions arise: How many section 87 settlements there are? What is the property comprised in each settlement? When was it acquired by the trustees thereof and for what consideration? What are the trust gains of each settlement? Who are the trustees of the arrangement settlement? In what circumstances will capital payments be made from the arrangement settlement?

Now each classic settlement will necessarily itself be a section 87 settlement.[14] Suppose that the trustees of the transferor settlement have realised section 87 gains in years before the transferee settlement existed or was ever contemplated, i.e. before, on any view, the arrangement consisting of both settlements came into existence. Suppose the arrangement to come into existence so that there are now three settlements, the two classic settlements and the arrangement. I cannot see how stockpiled gains of the transferor settlement can be trust gains of the arrangement. This is particularly clear where they are gains of a year of assessment before the arrangement came into being. This point in my view equally holds good where the gains have been realised at any time before the arrangement came into being.

When does the arrangement come into being? In my view, there will be no arrangement until something has actually been done. Mere planning is not enough. Arrangement must be construed eiusdem generis with disposition, trust, covenant, agreement ... or transfer of assets. In the circumstances envisaged, even the

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13 The position is different if there are separate trustees of sub-funds which are for capital gains tax purposes part of the same classic settlement: see *Roome v Edwards* [1981] STC 96; 54 TC 359 (HL).

14 I appreciate that this will not be so in the case where (as is common with employee trusts) there is an absence of bounty on the part of the settlor. Where the trustees of a transferor trust transfer assets to a transferee trust in exercise of their dispositive powers, the element of bounty will be satisfied in relation to the transferee trust if it was satisfied in relation to the transferor trust: see *Chinn v Collins (H M Inspector of Taxes)* 54 TC 311 (1980) per Lord Wilberforce at page 351 last divide and per Lord Russell at page 357 first divide.

bringing into being of the transferee settlement will not be enough. There must be an actual transfer between the settlements.[15]

What are the assets owned by the trustees of the arrangement? How do they come to own them? What is their base cost? How long are they deemed to have owned them for the purposes, for example, of indexation relief or taper relief? As such trustees are not a person for capital gains tax purposes, these questions seem quite intractable.

What of gains realised once the arrangement is in existence? How does one identify a gain realised by the trustees of the arrangement rather than by the trustees of one or other of the classic settlements? This is another aspect of one of the questions raised in the previous paragraph, namely, how does one identify the property held by the trustees of the arrangement?

Or can it somehow be said that all gains realised by either set of classic trustees are deemed to be realised by the trustees of the arrangement? I do not myself see how. What is to stop them being trust gains of the section 87 settlements constituted by each settlement? The presumption against double taxation is still very strong. What if the trustees of the transferor settlement have made transfers to more than one transferee settlement? If the transferee settlement is part of more than one arrangement, to which arrangement does one attribute a gain of the transferor trustees?

The Revenue might take a more limited line and allege that only assets transferred from the transferor settlement to the transferee settlement are comprised in the arrangement. Is this not a little more promising for them, as at least there will have been a transfer from one settlement to another, which will crystallise gains in the transferor settlement and give the trustees of the transferee settlement assets with a clear acquisition date and cost? But, wait a moment, we are seeking to identify assets owned by the arrangement section 87 settlement, not by the transferee classic settlement (which is also a section 87 settlement), whether viewed as a classic settlement or as a section 87 settlement. The mere fact that for capital gains tax purposes in general there is a disposal to the trustees of the transferee settlement makes it difficult to argue that at the same time there has been a disposal of the same assets to the trustees of a different section 87 settlement.

What if the gains arise on the disposal of assets which can somehow be said to be acquired after the arrangement comes into being by the trustees of the arrangement, rather than by the trustees of one or other of the classic settlements? Here again,

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15 See further the discussion below of *Ewart v Taylor*.

there is a difficulty in identifying such assets or in calculating any gain on the disposal of any assets which might be so identified.

What constitutes a capital payment received from the trustees of the arrangement? It might be said that it is enough if it is received from the trustees of either classic settlement. That is not without difficulty, as each have their own assets. It is particularly difficult where the payment is made by the trustees of the transferor settlement, not quite so difficult where it is made by the trustees of the transferee settlement. How does one determine whether a payment in fact made, say, by the trustees of the transferee settlement is to be treated as made by the trustees of the arrangement? What is to stop it doing double duty, thus resulting in potential double taxation?

In short, the more one explores the position, the more absurd it becomes. My main thesis, that there cannot be an arrangement section 87 settlement distinct from the classic settlements, is reinforced. Even if that is for some reason wrong, it would still appear that claiming there is an arrangement which is a section 87 settlement will not enable the Revenue to argue that pre-arrangement trust gains of the transferor settlement can be visited on beneficiaries of the transferee settlement who receive capital payments from the trustees thereof. It is precisely to enable that to be done that Taxation of Chargeable Gains Act 1992 section 90 (Transfers Between Settlements) and Schedule 4C (Transfers of Value: Attribution of Gains to Beneficiaries) were enacted. They were clearly needed. The tax avoidance scheme referred to in section 1 above relies on what is perceived as a gap in those provisions.

4 *Chinn v Collins*[16]

4.1 The Facts

The only House of Lords case which throws any light on the meaning of arrangement in the capital gains tax context is *Chinn v Collins*. Technically, the case concerned Finance Act section 42. Although it attributed trust gains to beneficiaries on a different basis, it is in some respects indistinguishable from Taxation of Chargeable Gains Act 1992 section 87. Section 42(1) provided:

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16 54 TC 311 (1980) HL; [1981] AC 533; [1981] 2 WLR 14; [1981] 1 All ER 189; [1981] STC 1.

> Any beneficiary under the settlement who is domiciled and either resident or ordinarily resident in the United Kingdom during any year of assessment shall be treated for the purposes of this Part of this Act as if an apportioned part of the amount, if any, on which the trustees would have been chargeable to capital gains tax under section 20(4) of this Act, if domiciled and either resident or ordinarily resident in the United Kingdom in that year of assessment, had been chargeable gains accruing to the beneficiary in that year of assessment ...

Hence, there needed to be trustees who would have been chargeable to capital gains tax if United Kingdom resident.

In *Chinn*, an existing trust was exported to Guernsey, the trustees appointed, with the consent of the settlor, interests in favour of the settlor's two sons which would become absolute on their surviving for three days. The sons then assigned by way of sale their interests, while still contingent, to Rozel, a Jersey company. The trust property consisted of quoted shares. The sons also contracted to buy from Rozel the same number of the quoted shares as Rozel expected to become absolutely entitled to as a result of the assignment. In those days, a gain accruing on the disposal of an interest under a non-UK resident settlement was in general exempt from capital gains tax and there was no deemed disposal of trust assets by the trustees on their emigration from the United Kingdom.

4.2 The Decision

The Revenue's first argument, which was accepted by the House of Lords, was that it was the *sons* who in fact became entitled to the settled shares as against the trustees of the trust, so that the trustees' gains could be imputed to them under section 42. At the time, this decision was highly suspect in terms of trust law. The decision of the Court of Appeal, in favour of the sons, seemed to be obviously correct. With hindsight, it is clear that it had nothing to do with trust law and was simply a harbinger of *Ramsay*: it was foreordained that the sons would become entitled to the trust shares and the sale of the contingent interest and the purchase of shares by the sons, being steps inserted purely to avoid tax, were consequently ignored.[17]

An alternative contention argument of the Revenue, which was also accepted by the House of Lords, was that the scheme as a whole constituted an arrangement, under

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17 This was the explanation given by Lord Templeman in *Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes)* [1992] STC 226.

which each son was a beneficiary, and that the trustees of that arrangement were the trustees of the trust. As their Lordships dealt with the point but shortly, it is more revealing to see how it was set out by Templeman J at first instance,[18] who dismissed the sons's appeals:

> In the alternative, the Crown claimed that if Anthony was not the beneficiary under the settlement, Anthony was, when the interest vested, the beneficiary under an arrangement. By s.42(7) of the Finance Act 1965 a settlement is defined so as to include an arrangement. On behalf of Anthony it was submitted that there were no trustees or settlor of any arrangement and that s.42(7) does not apply in the present circumstances. In my judgment, all the relevant events which took place between the appointment of new trustees dated 31st March 1969 and the final transfer of the shares to Anthony were part of an arrangement instigated by the settlor and carried into effect by him, by the trustees, by Rozel and by Anthony. The trust fund, the subject of the arrangement, consisted of 184,500 shares. That trust fund was vested in N.M. Rothschild & Sons (CI) Ltd and the other three trustees of the settlement. They were the trustees of the arrangement because they held the trust fund which was comprised in the arrangement. Similarly, the settlor was the settlor of the arrangement because he was the person who had provided the trust fund comprised in the arrangement. There is no doubt that for the purposes of the arrangement the only beneficiary was Anthony, and that when the contingent interest vested he was, pursuant to the arrangement, absolutely entitled to the shares. Accordingly it seems to me that the Crown are entitled to succeed on this alternative ground also.

4.3 Problems

The main difficulty in reading the case is that Charles Potter QC for the sons, appears to have argued that for there to be an arrangement there must be bounty and therefore a person who has provided bounty; that there could therefore be no arrangement in this case on that account. That argument was rejected for reasons which are not unconvincing but are not material to the present discussion. According to the speech of Lord Roskill, however, that was the only argument put forward on this aspect of the case. The resulting position is highly unsatisfactory. While answering some questions, it leaves more unanswered.

Firstly, even if the appointment of a beneficial interest to Anthony did constitute a new arrangement and therefore a new settlement, he had ceased to be a beneficiary

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18 At page 328.

of it the moment he assigned that interest, just as he has at that moment ceased to be a beneficiary of the classic settlement.

Secondly, Templeman J claimed that the trustees of the classic settlement were also the trustees of the arrangement because they held the trust fund which was comprised in the arrangement. This was patently false. The trust fund was not comprised in the arrangement. Only the contingent interest was and the trustees of the classic settlement clearly did not hold that.

A third difficulty was mentioned by Goff LJ in the Court of Appeal, in rejecting the Revenue's submissions:

> First, I do not for myself see how the Crown can mount a case under s.42(7) unless they can show, which was not shown, that the arrangement in some way superseded the classic settlement [i.e. the trust]. Under that settlement and in the events which happened, Rozel was the only beneficiary within [Finance Act 1965] s.42(2) and would have been liable for the whole tax had it not been an overseas company, and I do not see how the Crown can escape that difficulty by looking to a different beneficiary under a different settlement, namely that constituted by the arrangement, but necessarily including the classic settlement itself, without in some way showing that the classic settlement taken alone had somehow ceased to be operative at the moment of the deemed disposal under s.25(3) of the Finance Act 1965. Mr. Nicholls sought to skate over this thin ice by using a variety of descriptions of the position. He said the arrangement was superimposed upon or flowed out of or was engrafted upon the classic settlement, but the stark fact remains that I do not think you can have both operative at the same time and producing concurrently a different result.

This reasoning is very powerful. The House of Lords simply ignored it: a well-tried judicial technique for dealing with a troublesome impediment to reaching the desired result.

4.4 Relevance to TCGA Section 87

4.4.1 Appointment of Beneficial Interests

Were the matter to arise in the context of Taxation of Chargeable Gains Act 1992 section 87, one could rely on an important point of distinction between the old and new Offshore Beneficiary Provisions. Under Finance Act 1965 section 42, trust gains were apportioned only to beneficiaries who were domiciled and either resident or ordinarily resident in the United Kingdom during a year of assessment. Under

Taxation of Chargeable Gains Act 1992 section 87, gains are apportioned to all beneficiaries and others, such as assignees of beneficial interests, who may not strictly be beneficiaries. The fact that gains of the trustees of the trust would now be attributed to Rozel as a beneficiary of the trust proper makes it very difficult to say that the very same gains should also be attributed to the sons as beneficiaries of the arrangement.

If one were faced with a similar argument today, rather than deal with this conundrum, it would be easier to circumvent it. There is another very important point of distinction between the old and new Offshore Beneficiary Provisions. Under Finance Act 1965 section 42, trust gains were apportioned each year of assessment to beneficiaries during that year irrespective of whether they received any capital payments from the trustees or not. Had *Leedale v Lewis* 56 TC 501 (1982) already been decided, *Chinn v Collins* could have been disposed of on the simple ground that it was just and reasonable to apportion all the gains of the trustees of the trust to the sons, on the basis that they were the beneficiaries who had received the gain. By contrast, under Taxation of Chargeable Gains Act 1992 section 87, gains of trustees can be visited only on persons who receive capital payments from the trustees of a settlement. Unless one takes the view that the appointment of a less than absolute beneficial interest to a beneficiary does involve the making of a capital payment, the sons could not now be made liable under section 87 even if there was an arrangement of the type contended for by the Revenue in *Chinn v Collins*.

4.4.2 Two Trusts one Arrangement?

Although, the apparent relevance of this rather unsatisfactory authority is much diminished by crucial differences in the wording and operation of the old and new Offshore Beneficiary Provisions,[19] is it none the less just plausible that two trusts could be regarded as one settlement for the purposes of Taxation of Chargeable Gains Act 1992 section 87?

Chinn v Collins itself does not go this far. It decided at the very most that an appointment of a beneficial interest under a trust could itself constitute a separate settlement of which the appointee was the beneficiary. The actual arrangement in that case was more complicated, involving the assignment on sale of the interests appointed and the contract of sale of shares. The Revenue accepted[20] that the assignment and the sale agreement were not by themselves within the extended definition of settlement because they contained no element of bounty and were

19 The old provisions being those in force from 1965 to 1981.

20 See the speech of Goff LJ at page 344.

effected for full consideration in money or money's worth.

Even if an appointment of a beneficial interest under a trust could itself constitute a separate settlement of which the appointee was the beneficiary, this would still not mean that a trust and an appointment under it constituted one and the same arrangement. Indeed, the Revenue's argument in *Chinn* was quite the contrary: it was only if there were two distinct settlements that they had a second bite at the cherry with their alternative argument. In my view, it is equally true that if two classic settlements could by virtue of a transfer between them constitute one arrangement, that section 87 arrangement settlement would still be distinct from either of the section 87 classic settlements which formed part of it.

5 *Ewart v Taylor* [21]

This case concerned a March 1965 settlement and a Jersey decanting settlement created in 1969 expressly for the purpose of receiving funds from the 1965 settlement. The trustees of the 1965 settlement shortly afterwards transferred the entire trust fund of that settlement to the trustees of the 1969 settlement. Counsel for the taxpayers submitted that the 1965 settlement, the deed of appointment transferring funds between the two settlements and the 1969 Jersey Settlement should all be regarded as part of an arrangement or statutory settlement, and that as the 1965 settlement was made before 5th April 1965, the taxpayers were entitled, under Finance Act 1965 section 42(4)(b), to defer payment of tax for which they were properly assessable.

Vinelott J held that even if the 1965 settlement, the 1969 settlement and the deed of appointment constituted an 'arrangement', it was not made before 6th April 1965. He took the view that an existing state of affairs was adapted for the purposes of an arrangement which as I see it was clearly not made before March 1969. With respect, that must be right. It means in the current context that gains of a transferor settlement realised before the transfer cannot be trust gains of the arrangement.

He also considered a submission of counsel for the Crown that as the 1969 appointment and settlement were not in contemplation when the 1965 settlement was executed, they could not be said to form part of an arrangement which comprehended the 1965 settlement. If that were correct, it would mean that there could be no arrangement settlement consisting of a transfer from a transferor to a transferee settlement, at least where the latter was not in existence when the former was made. Vinelott J was not persuaded that the submission was well founded. He

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21 [1983] STC 721.

relied on *Crossland (Inspector of Taxes) v Hawkins* [1961] Ch 537; 39 TC 492, where the courts rejected a submission by counsel for Mr Hawkins that to constitute an 'arrangement' the whole of it must be in contemplation at the outset, when the first transaction relied on as part of the arrangement is entered into.

In *Crossland v Hawkins*, everything happened in one income tax year. Donovan LJ said that there was sufficient unity about the whole matter to justify it being called an arrangement for this purpose, because ... the ultimate object is to secure for somebody money free from what would otherwise be the burden, or the full burden, of surtax. Merely because the final step to secure this objective is left unresolved at the outset and decided on later, does not seem to me to rob the scheme of the necessary unity to justify it being called an 'arrangement'.

Vinelott J, while noting that in *Ewart v Taylor* a considerable period had elapsed between the making of the 1965 Settlement and 12th March 1969, when the 1969 settlement and deed of appointment were executed, was still not satisfied that that was a sufficient ground for distinguishing *Crossland v Hawkins*. In that case the formal settlement was, as it were, built on to existing foundations, a scheme devised to divert Mr Hawkins' earnings into a company, which was then adapted to procure that the benefit of those earnings went to Mr Hawkins' children. In the instant case funds set aside on trusts for the settlor's issue were similarly transferred by means of the exercise of powers conferred by the [1965] settlement into another settlement created only for the purpose of receiving them.

To my mind, Vinelott J does understate the important differences between the two cases. It is one thing for a strategy to be begun to be implemented while the final stages are not entirely clear. It is another thing for the first stage to be undertaken without any reference to any further stage and to be complete in itself.

However that may be, I do not consider that the decision has any relevance to the current question. His comments were obiter and of limited scope. Even if correct, they do not go any way towards answering the objections I raise earlier in this article. In fairness to him, the points were not argued before him. Counsel for the taxpayer had no incentive to do so and counsel for the Crown thought, rightly, he could succeed on other points.

6 Conclusion

In my view, two classic settlements between which there is a transfer of assets cannot constitute one arrangement. Even if they could, that would not of itself result in the imputation of gains of the transferor settlement realised before the arrangement came into being to beneficiaries who received capital payments from the trustees of the transferee settlement. If, however, the question is raised in a tax-avoidance context, there can be no guarantee that the courts would not hold the contrary for reasons good, bad or atrocious.